Ingimundur Friðriksson: The impact of monetary policy

Speech by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, at the University of Akureyri, Akureyri, 3 October 2007.

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Iceland's economy has been characterised by strong imbalances in the recent past, and still is. The current expansionary episode was driven by large-scale investments in the aluminium and power sectors that were launched several years ago, and in structural changes in the mortgage loan market that led to a surge in credit-driven private consumption. Disposable income has also grown at an exceptionally fast pace. Just over a year ago, inflation measured 8½%. The current measurement is just over 4%, while underlying inflation is likely to be in the range 6-7%. In spite of overheating and excess demand, the inflation rate has thus been slowed down. Primarily, this result has been achieved with tight monetary stance. Without it, inflation would have been much higher, with all the exchange rate volatility, erosion of living standards and disruption to business operations that this would have entailed. Many claims have been made recently about the inflation target and the Central Bank's recourses for attaining it – or the lack of them. The problem now is not the framework of monetary policy or its implementation, but rather the lack of necessary support for the Central Bank's measures. The tight monetary stance will be maintained and tightening is also needed elsewhere, in fiscal policy and lending decisions by financial companies. Macroeconomic balance will be difficult to achieve otherwise. An easing of the monetary stance now would simply be misguided and have unforeseeable consequences. The Central Bank would be failing in its mandatory duties if inflation were temporarily "let loose" to achieve supposed results in other areas. In the following speech I shall present arguments in support of this view.

After maintaining a fixed exchange rate regime for more than a decade, Iceland adopted inflation targeting in March 2001 with a joint declaration by the Government and the Central Bank. The target is a twelve-month rate of increase of 2½% in the CPI. For much of the time the fixed exchange rate regime served its purpose, but towards the end, following the full deregulation of cross-border capital movements, more exchange rate flexibility was clearly required than the fixed regime could allow, even after the tolerance bands had progressively been widened from their original 2¼% to 9%, i.e. the króna was permitted to deviate by up to 9% from its central rate when the policy was abandoned. A return to a fixed exchange rate regime is out of the question. Since it could never be credible in practice, it can be ruled out – unless currency restrictions were to be reimposed, which is hardly on anyone's agenda.

Inflation targeting has proved a successful tool of monetary policy in many parts of the world. Well over two dozen central banks now target inflation, including those of various industrial countries such as the UK, Sweden, Norway, Australia and New Zealand. The European Central Bank can also be said to target inflation in practice, without a formal commitment. Broadly speaking, all these central banks have a similar approach. Inflation targeting requires careful preparation of forecasts for economic aggregates – not least inflation – a high degree of central bank transparency and effective instruments and transmission channels for policy measures.

Iceland moved onto an inflation target under fairly difficult conditions. The króna had weakened substantially and was close to the lower tolerance limits when the new policy was adopted. It then depreciated rapidly in spring 2001. The consequence was a surge in inflation, which peaked at around 9½% at the beginning of 2002. Subsequently it declined sharply, not least on account of the tight monetary stance, and the 2½% target was attained later the same year. For some time inflation remained below or around target, but since the first half of 2005 it has overshot, and was well above target for a while. The various reasons for this development have been described in detail in recent Central Bank publications and I shall not elaborate them upon over and above the causes I have already mentioned.

In order to attain its inflation target, the Central Bank has a single instrument: the policy interest rate. The policy rate applies to Central Bank facilities for financial companies and its impact is transmitted through them into the economy. When inflationary pressures are looming or building up, the Central Bank raises its policy rate in order to make credit more expensive and reduce investment and consumption, encouraging saving at the same time. The policy rate is not applied to achieve other objectives than the inflation target. Thus it is pointless to set other objectives for monetary policy except by abandoning the objective of price stability, which would be particularly imprudent.

Steady enhancements have been made to the conduct of monetary policy. Forecasting has strengthened with a new and much more powerful macroeconomic model. A landmark was reached this year when the Bank began publishing its staff's projection for the policy rate path that is compatible with attaining the inflation target within an acceptable timeframe. Previous interest rate assumptions had proved unsatisfactory and even misleading. Publication of the policy rate path has been welcomed and has facilitated the Central Bank in exerting the impact that it intends to have on market expectations. International agencies and foreign analysts who monitor economic developments in Iceland have praised the Central Bank's monetary policy implementation, transparency and professionalism. It is interesting to note that these assessments are at odds with widespread attitudes in Iceland at the moment.

In the climate that has prevailed recently, the Central Bank's policy rate hikes have admittedly affected the exchange rate of the króna first, then demand much later. Among the explanations is that policy rate hikes have not had what should have been their normal effect. This has complicated the Bank in its efforts to constrain inflation in recent times. One factor has been the changes that took place in the mortgage loan market in autumn 2004 when the commercial and savings banks began competing with the Housing Financing Fund (HFF). The Central Bank's policy rate hikes impact the interest rates of non-indexed lending by commercial banks and savings banks and the non-indexed end of the domestic bond market. However, for a long time they had little impact on long-term interest rates. Some critics cite this as proof that the Central Bank of Iceland's measures do not have the same effect as those of other central banks. Yet the development in Iceland is by no means an isolated occurrence. The US experience offers an immediate example. The Federal Reserve began raising its federal funds rate early in 2005 in progressive steps until early this year, from 1% to 5.25%. These hikes had no effect on long-term interest rates in the US, which have been broadly steady since 2005 apart with only minor fluctuations in either direction. US monetary authorities were puzzled by this development. I cite this example because it has been claimed that, unlike the Central Bank of Iceland's decisions, the impact of changes in the Federal Reserve's rates is immediately transmitted in full to long-term interest rates.

One reason for Iceland's limited success in keeping inflation in check has been precisely that the impact of the Central Bank's policy rate hikes has not been transmitted in full to the mortgage loan market. In particular this is because one of the players there, the HFF, enjoys Treasury guarantees on its borrowing, enabling it to meet its funding requirement by issuing bonds at very long maturities with lower yields than on shorter issues, so that it can avoid raising interest rates on its new lending, which under normal circumstances would have been warranted and called for by the Central Bank's monetary stance. Since autumn 2005, market yields on indexed bonds have risen in the range ½ to 2 percentage points, depending upon the issues involved. At the same time, HFF interest rates have gone up by half a percentage point. So it cannot be said that Iceland faces the same conundrum as the US about why long-term interest rates have not risen in the wake of policy hikes.

House prices began to increase significantly again last spring, in the teeth of general expectations, and have been the main driver of the CPI in recent months. It is not unlikely that the latest wave of price rises in the housing market is at least partly due to decisions by the government and HFF last winter to raise the loan-to-value ratio and mortgage ceilings and to lower interest rates on new lending. Even though neither the changes nor amounts involved were large, there is little doubt that they had some effect and prompted a new marketing drive by the banks. In a climate of rapidly growing disposable income, house prices began to soar again.

The Central Bank has emphasised the need to change the public sector mortgage credit system but has not stated an official view as to how this should be done. Nonetheless, immediate reforms are vital to give monetary policy more leverage over the mortgage loan market. Another important consideration is that whatever mortgage loan arrangements that are developed should provide a solid foundation for the domestic bond market. The Central Bank has been making these points for several years with little result. International agencies have agreed that a review of the role of the HFF is long overdue. Particular mention may be made of the IMF, most recently this summer. The Fund's reports show that its analysts have striven to make an in-depth study of mortgage credit arrangements in Iceland. In its Article IV Consultation report published in June, the IMF claimed that a higher policy rate than otherwise had been needed as a result of the HFF's activities.

It should be added that one reason for the limited success in keeping the lid on inflation has been an enormous increase in disposable income in 2006 and 2007, driven by both wage rises and tax cuts. These factors and others have fuelled domestic demand and thereby inflationary pressures.

The Central Bank has pointed out how the small amount of outstanding Treasury bonds in the market hinders policy rate changes from being transmitted with the necessary weight. Price formation in the bond market is imperfect. The Bank has aired the idea that the Treasury should issue bonds with the explicit purpose of maintaining an active bond market. Of course, such a suggestion must be qualified by the fact that the Treasury is on the verge of eliminating its net debt and has no need to borrow. The Central Bank's standpoint, however, is that given the significance of domestic capital markets, the importance of facilitating the impact of monetary policy measures and long-term strategies for Treasury funding, it is in the Treasury's interest to maintain a smooth bond market, even though it has no direct funding requirement. One example of Treasury issuance on such principles is Norway, which has had even less need to borrow than the Icelandic government.

Claims have been heard that the Central Bank's monetary policy is either impotent or wrong, and that the Icelandic króna is the root of macroeconomic instability. The Central Bank has pointed out that one consequence of globalisation and Iceland's integration with global capital markets, coupled with the exceptionally intense upswing experienced in recent years, has been that the transmission mechanism of monetary policy has altered. In this climate, the impact is transmitted with greater force to the exchange rate, and only later to domestic demand, as I mentioned earlier. This is reflected in a stronger króna than otherwise, which other things being equal delays the adjustment of the current account deficit. Nonetheless, it is impossible to demonstrate that monetary policy is impotent. Anecdotal evidence about households and businesses being squeezed by high interest rates confirms that the opposite is true. Monetary policy does work, and will eventually impact demand and thereby the current account deficit.

Inflation soared in the recent term to peak at 8½% just after mid-2006, as I mentioned before. The Central Bank made a particularly sharp response to the deteriorating inflation outlook last year with a large hike in the policy rate on the back of sizeable earlier increases. There is no question that the tight monetary stance entailed by these measures reversed the development and drove inflation down, as subsequent data have shown. In its *Monetary Bulletin* published in July this year, the Central Bank forecast that inflation would be close to target in 2008 and it would be attained in full in 2009. Of course events are unfolding in this way as a result of the tight monetary stance and it is absurd to claim otherwise. It can even be argued that the Bank should be criticised instead for not raising rates enough and quickly enough. I am referring here to the shortcomings I mentioned in the transmission of policy rate hikes and insufficient restraint in other areas of the economy.

A tighter Central Bank monetary stance makes borrowing more expensive. The aim of such tightening is to dampen demand. Competition with the HFF doubtless made the commercial banks reluctant to raise their mortgage lending rates, in spite of having full grounds for doing so. This situation has changed recently and a sizeable spread has developed between mortgage lending rates of the banks and the HFF. In other words, the tighter stance is beginning to be felt in the banks' mortgage rates. Competition with the HFF has undoubtedly prompted the banks to be more aggressive in marketing their mortgage loans denominated in foreign currencies, which in the present climate can be expected to offer them better returns than indexed lending in domestic currency. It is a different matter whether borrowers in foreign currencies have been fully aware of both the exchange rate and interest rate risks entailed by doing so, which the Central Bank has repeatedly cautioned against.

It has also been claimed that the Central Bank has raised its policy rate excessively and that it is now far too high. The only possible inference is that critics of these measures would have preferred a much higher rate of inflation. Had the Central Bank not made these policy rate hikes, the outcome would have been much higher inflation, falling living standards and a heavier debt burden for households, the majority of which have a high level of indexed debt. Another consequence would have been to drive up inflation expectations, which experience shows are difficult to unwind. Inflation cannot be switched on and off at will. If the Central Bank had not maintained a tight monetary stance and not raised the policy rate as it has done, it is almost certain that the economy would be swept into a familiar spiral of inflation, currency depreciation and wage rises, benefitting no one but harming us all, as historical experience has taught us.

One of the fiercest critics of Central Bank monetary policy has been the Confederation of Employers. They have dismissed the Bank's monetary policy as having no effect, while claiming that inflation excluding the housing component of the CPI has been only 2½% for some time, and then infer that monetary policy has had no impact on that development, however they manage to reach that conclusion. The Confederation of Employers has suggested monetary policy reforms along the following broad lines: First, to relax the inflation target; second, to remove house prices from the target CPI; and third, to impose a corridor for Iceland's policy rate differential with abroad, e.g. the European Central Bank. The Central Bank does not consider that any of these proposals would improve monetary policy implementation. On the contrary. Easing the inflation target is highly inadvisable. That would probably drive up inflation expectations of households and businesses and anchor inflation at a higher rate than would be tolerated in neighbouring economies, with correspondingly bad consequences. We should not set less ambitious goals than others.

The Central Bank has previously declared its firm support for including house prices in the CPI on which the inflation target is based. Since the housing component reflects an important share of the cost of living for households, it is natural to include it. Also, the CPI including mortgage costs is a more stable gauge of inflation than if they are excluded. House prices are a leading indicator as well. A sharp rise signals private consumption growth later on, enabling the Bank to respond more quickly to demand pressures. Finally, if the housing component were removed from the index now, inflation would probably measure higher than otherwise in the period ahead, assuming that house prices increase by less than the general price level, as has been forecast for some time. Thus it is difficult to envisage the gains from removing the housing component now. A more obvious measure would be to make it easier for the Central Bank to impact mortgage interest rates, as I discussed earlier.

A cap on the policy interest rate differential with abroad would merely cause problems. Simply consider what would have happened had Iceland not been allowed to set its policy rate more than two percentage points higher than the ECB in recent times – which is the differential proposed by the Confederation of Employers. It is almost certain that Iceland would be struggling with very high inflation and all the disruption this would entail. Precluding such consequences would have called for a draconian fiscal stance and constraints on wage rises. Both would have been very difficult to achieve and are outside the Central Bank's sphere of influence anyway.

Yet another allegation has been that the Central Bank is in a straitjacket and will never be able to lower the policy rate. The Bank disagrees. I have already mentioned changes made to the Bank's forecasting techniques earlier this year which included publishing the policy rate path that, in the staff's assessment, would suffice to bring inflation to target within an acceptable timeframe. The Central Bank has repeatedly stated that the policy rate will be brought down as soon as conditions allow this to be done, but not before. The forecast published in July implied that the policy rate would be lowered in the first half of 2008. I should point out that Iceland has run up a huge current account deficit. This will narrow somewhat this year and is forecast to decline slowly but surely. A wide current account deficit creates uncertainty concerning the exchange rate of the króna. A smaller current account deficit reduces this uncertainty, so that conditions could remain for ongoing glacier bond issuance, for example, despite the narrower interest rate differential with abroad.

More views have been aired recently. One was that the prevailing global financial climate presents a unique opportunity for the Central Bank to cut its policy rate. In the same breath it was underlined that the Bank needs to cool the economy. These two perspectives are incompatible. The need to review the assumptions on which the Central Bank Act was based when it entered into force in 2001 has also been mentioned. Let us recall that at the end of 2000, the Prime Minister assigned a committee representing the four largest political parties in parliament with the task of drafting new Central Bank legislation. A complete draft bill was delivered in March 2001, backed by the entire committee. This was passed as law virtually unamended with the unanimous support of all 56 members of parliament who were present for its final reading. The Act represented a major reform. It granted the Bank increased independence, simplified its objectives and made greater demands for transparency and professionalism. A review of the assumptions behind this legislation or amendments to it will obviously not reduce the current macroeconomic imbalances. Other action is needed.

The issue is actually very straightforward. Iceland's economy has been overheating for a long time. This is the result of massive domestic investments, radical changes in the domestic financial sector when the banks began providing mortgage loans in competition with the HFF, and exceptionally large increases in household disposable income stemming from increases in pay and tax reductions. All this happened under external conditions in which interest rates were at a historical low. The consequence was buoyant domestic demand, private consumption and investment, which have been reflected in inflation and a large current account deficit. Macroeconomic imbalances have been too pronounced for monetary policy alone to contain them, exacerbated by special conditions that have hindered measures from having the necessary effects. Other aspects of economic policy would have needed to be tightened, in particular the fiscal stance, even though the Treasury is much better placed than in most other countries, with virtually zero net domestic and foreign debt which by itself is a notable achievement. Financial companies would also have needed to show more prudence in their lending decisions and they should be encouraged to display the utmost caution in this respect.

In public debate in recent weeks and months, there have been occasional calls for Iceland to adopt a different currency. Without expressing any opinion on the issue here, I would point out that this cannot be done overnight and it is crucial not to act rashly. The current debate appears to be prompted by the recent volatility of the króna. I hardly need to mention the great volatility that has been witnessed in capital markets, exchange rates, interest rates and securities prices around the world in recent weeks. Iceland has not escaped this trend any more than other countries, but the fluctuations it has experienced have not been sharper than in many others. A key precondition for joining a monetary union is to achieve macroeconomic balance. Whatever the outcome of the currency debate, the problems of the day will not vanish without being tackled, and that takes time. They will not be solved with miracle cures or ill-advised changes to individual aspects of monetary policy conduct. Monetary policy works. However, it needs support, along with necessary reforms to strengthen its effectiveness. There are no alternatives. But under today's conditions, where developments in global markets have more direct impact on the Icelandic economy, it is vital for all economic policy measures to have a coordinated focus on restoring macroeconomic stability. This must be the priority. The same principle applies in all countries in a similar position, not least in relatively small and open economies. Relaxing the stance of monetary policy is by no means the answer and it is important not to undermine its credibility.

On September 6 this year, the Board of Governors of the Central Bank of Iceland decided to leave the policy interest rate unchanged at 13.3%, as it has been since December 2006. The Board of Governors considered that the short-term inflation outlook had deteriorated somewhat since the previous interest rate decision in July, but long-term prospects were unchanged. Exchange rate developments were highly uncertain and would largely be determined by developments in global financial markets. The Board of Governors concluded its announcement by reiterating its commitment to attaining the inflation target within an acceptable timeframe. The next interest rate decision by the Board of Governors will be announced on November 1, 2007, coinciding with the publication of *Monetary Bulletin* and the Bank's new macroeconomic and inflation forecasts.

The twelve-month rise in the CPI in September measured 4.2%. This was a higher rate of inflation than the Central Bank had expected. Revised macroeconomic aggregates published in mid-September also showed that the economy is more robust than preliminary statistics had indicated. It should be pointed out that the labour market is still extremely tight, with unemployment of less than 1% in spite of large-scale imports of labour. The only conclusion that can be drawn is that inflationary pressures are still stronger than had been expected, and the challenge ahead correspondingly greater. I repeat that this will not be solved with a laxer monetary policy or changes to the monetary policy framework. Reining in inflation is vital for the interests of households and businesses. Iceland now has the same monetary policy framework as many other countries. Most of them have been more successful than we have in containing inflation. Neither have they had to accommodate investments on the scale that Iceland has witnessed, relative to the size of the economy, and their domestic capital markets have not undergone as extensive and sharp changes as Iceland experienced when the banks entered the mortgage loan market. At the same time it is unlikely that household disposable income in any country has risen on the scale seen in Iceland over the past two years.

In most countries it is considered natural to set price stability as an objective for central banks. They can only have a short-term impact on other aggregates. Under present conditions Iceland has no option of a different monetary policy framework. Failing to support monetary policy in efforts to achieve the intended results would be an act of surrender and have dire consequences.